APPLICATION OF

B & J ENTERPRISES, L.C. **CASE NO. PUE990616**

For a certificate of public convenience and necessity to operate a sewage utility

REPORT OF MICHAEL D. THOMAS, HEARING EXAMINER

December 20, 2000

HISTORY OF THE CASE

In June 1999, the Division of Energy Regulation (the "Staff") received three complaints regarding the service provided by B & J Enterprises, L.C. (the "Company"). The Staff investigated the complaints, and determined the Company was operating a sewage utility without the benefit of a Commission-issued certificate of public convenience and necessity ("CPCN"). In 1995, the Company acquired the sewage treatment system and a number of undeveloped lots from Blacksburg Country Club, Inc. ("BCC, Inc."), the former developer of the Blacksburg Country Club Estates ("BCC Estates"). The sewage treatment system was initially placed in service in 1971, and BCC, Inc. should have applied to the Commission for a CPCN when its connections surpassed 50 residential building lots, which was sometime around 1984. On June 21, 1999, the Staff requested that the Company apply for a CPCN.

On September 2, 1999, the Company filed an Application and accompanying exhibits with the Staff requesting the issuance of a CPCN to operate a sewage utility. In its Application, the Company proposed a service charge for residential sewer service of $34 per month; an availability charge of $20 per month; a service connection fee of $17,500; a disconnection and reconnection fee of $5,000; and other miscellaneous charges.

On September 8, 1999, the Staff filed an affidavit of Marc A. Tufaro, assistant utilities analyst, stating the service connection charge and the reconnection charge appeared unreasonable because they far exceeded similar fees charged by sewage utilities regulated by the Commission, county sewage systems, and public service authorities operating under like conditions.

By order entered on September 9, 1999, the Commission docketed the case and suspended the proposed service connection fee to the extent the fee exceeded $3,000, for a period of 150 days from September 2, 1999. Further, the Commission suspended the proposed reconnection fee altogether for the same period of time; directed the Company to provide public notice of its Application for a CPCN; and directed the Staff to file a report on the Application by January 15, 2000.

On October 18, 1999, the Commission received a petition signed by 37 customers, representing 25 connections, requesting a hearing on the Company's Application. In their request, the customers stated the proposed rates for sewer service were arbitrary and excessive; there was no

mention of the connection fee or reconnection fee in the copy of the Application filed in the Montgomery/Floyd Regional Library; and there was no justification in the Application for any of the proposed fees or charges.

The Commission also received letters from two customers expressing their concerns with the Company's installation of sewer mains and the Company's proposed service connection and reconnection charges. The Blacksburg Country Club Homeowners' Association ("BCCHA") also filed a letter which provided background information on the rates previously charged by BCC, Inc. and a comparison of connection fees charged by nearby localities.

On January 21, 2000, the Staff filed a Motion for Extension and to Set Hearing Date, stating it had difficulty obtaining, reviewing, and verifying information from the Company, and therefore, it needed additional time to file its testimony. The Staff further argued the number of requests for a hearing warranted setting the matter for a public hearing.

By order entered on February 15, 2000, the Commission granted the Staff's Motion for Extension; established a procedural schedule for filing testimony and evidence; ordered the Company to provide notice of the procedural schedule for the Application; and appointed a hearing examiner to conduct all further proceedings in this matter, including scheduling a public hearing.

On March 9, 2000, the Company filed a motion requesting an extension of time to provide public notice to its customers and to file proof of notice with the Clerk of the Commission. By Hearing Examiner's Ruling entered on March 10, 2000, the Company's motion was granted and a public hearing was scheduled for June 6, 2000, in the General District Court, Blacksburg, Virginia.

Mrs. Joan G. Moore filed a Notice of Protest with the Commission on May 24, 2000. In her Notice of Protest, she stated the Company failed to make a copy of its prefiled testimony available in the Montgomery/Floyd County Regional Library by April 7, 2000, as required by the Commission's Procedural Order. She further stated the testimony was not placed in the library until May 18, 2000. As a consequence, Mrs. Moore requested that the Commission accept her Notice of Protest out of time.

On May 26, 2000, the Staff filed a Motion to Continue Procedural Schedule arguing that the Company's failure to timely file its prefiled testimony in the Montgomery/Floyd County Regional Library precluded interested parties sufficient time to review the testimony, or to prepare discovery. In addition, the Staff stated it was advised the Company failed to provide notice of its Application to its availability customers. The Staff requested that the June 6, 2000, hearing be continued, and a revised procedural schedule be established for the Protestants to prefile testimony and conduct discovery.

By Hearing Examiner's Ruling entered on June 1, 2000, the hearing was rescheduled for July 31, 2000, and the Company was directed to provide notice to its availability customers. In addition, a procedural schedule was established for Protestants, the Staff, and the Company to file additional testimony and exhibits.

On June 28, 2000, Mrs. Moore timely filed her Protest in this matter.

The hearing on the Company's Application was convened as scheduled on July 31, 2000. The Company appeared by its counsel Kodwo Ghartey-Tagoe, Esquire, and Paige Lester, Esquire. The Staff appeared by its counsel William H. Chambliss, Esquire. The Protestant, Mrs. Joan G. Moore, appeared *pro se*. The Company's proof of notice was accepted into the record as Exhibit A. A copy of the transcript of the hearing is included with this Report. All parties filed post-hearing briefs.

SUMMARY OF THE RECORD

Five public witnesses testified at the hearing. Mr. John Moore, a resident of BCC Estates, testified he is concerned the Company may possibly be paid twice for the same sewer system improvements. He specifically mentioned the sales contract between BCC, Inc. and the Company. The contract provides for the Company to receive a number of undeveloped lots in return for: (1) paying off a $42,000 construction loan; (2) upgrading or building the roads in the subdivision to Virginia Department of Transportation ("VDOT") standards; (3) providing sewer service to the property line of all lots currently owned by individuals and not currently served by sanitary sewer; and (4) assuming all of BCC Inc.'s real estate development and operations obligations in regard to all phases of BCC Estates. Mr. Moore testified the Company used three sewer connection fees ($30,000) collected from homeowners to pay off part of the construction loan. Mr. Moore argued this appeared to be a double payment to the Company because the proceeds from the sale of the undeveloped lots were to be used to extinguish the loan. Mr. Moore further testified the sewer connection fees collected by the Company, by its own admission, were also used to cover the costs associated with upgrading the roads and extending the sewer system in the subdivision. Mr. Moore argued this appeared to be a misuse of the sewer connection fee because the proceeds from the sale of the undeveloped lots should have been used to cover these costs. (Tr. at 7-12).

Mr. Moore testified that about $202,000 of the sewer construction costs claimed by the Company to provide sewer service to the property line of all lots should have been removed from the rate base calculation of Company witness Dooley. Mr. Moore argued the Company had already received payment in the form of undeveloped lots for extending the system to all lots owned by individuals, but not currently served by sanitary sewer service. Mr. Moore testified that requiring the homeowners to pay the Company again for something for which it had already received compensation would be unfair. Finally, Mr. Moore asked the Commission to also consider the written comments he filed in reaching its final decision in this case. (Tr. at 9-11).[1]

On cross-examination, Mr. Moore confirmed there were 62 undeveloped lots and a ten-acre undivided tract of land known as "The Hill," which conveyed under the sales contract. In addition, the contract transferred ownership of the sewage treatment plant to the Company, and 220,000 square feet of land in the flood plain along the North Fork of the Roanoke River. Mr. Moore was not sure whether the land in the flood plain is suitable for development. Mr. Moore believes there were about 35 lots owned by individuals and not served by sanitary sewer when the sales contract was signed in 1995. Mr. Moore testified there was one lot under contract at the time and the

[1] *See*, Written comments of John Moore dated April 18, 2000.

proceeds of the sale were to be set against the outstanding $42,000 construction loan. Mr. Moore testified the sales agreement contains a provision that limits the rates that may be charged by the Company to the highest rates charged by the Montgomery County Public Service Authority or the Towns of Blacksburg or Christiansburg. Finally, Mr. Moore testified the Company informed the homeowners by letter in September 1999, that in the future all sewer services would be provided by Country Club Wastewater Systems, LLC. ("CCWWS"). (Tr. at 16-26).

Mr. Joseph V. Gorman, Jr., the president of BCC, Inc. on July 15, 1996, the date the undeveloped lots were conveyed to the Company, and a current member of the Montgomery County Public Service Authority, testified that the recommendations of Staff witness Tufaro and the testimony of Protestant Mrs. Moore were complete and accurate. He suggested, however, that the Staff recommendations concerning the treatment of availability fees be modified to mirror those currently used by the Montgomery County Public Service Authority. Apparently, the fee structures are defined and applied differently. Mr. Gorman defined a "Connection Fee" as the cost of connecting to the operating system, which is based on the cost of the material and labor to perform the connection. A "User Fee" is a monthly charge to the customer to cover the cost of the operations, maintenance, debt service, and overhead of the existing wastewater treatment system. An "Availability Fee" is established to cover the capital cost of expanding the system, and is made on all new connections to the system. Mr. Gorman suggested the Commission should relieve those persons who connected to the system prior to July 16, 1996, and who paid a connection fee, from the requirement of paying a monthly availability fee. (Tr. at 29-31).

Mr. Gorman further testified the sewage treatment plant was in operation within discharge limits and suitable for at least 25 more connections before the Company undertook expansion of the system. The expansion of the system was a necessary component of the contingent liability for which the 62 undeveloped lots were conveyed to the Company. (Tr. at 31).

With respect to the requirement in Section 6 of the sales contract that the sewer rates not exceed those in the surrounding community, Mr. Gorman provided the current rates, as of July 31, 2000, for the Montgomery County Public Service Authority ($500 Connection Fee, $2,500 Availability Fee, and $26.50 Monthly Fee), Blacksburg ($1,009.75 Connection Fee, $701.75 Availability Fee, $36.49 Monthly Fee), and Christiansburg ($750 Connection Fee, $7.50/front foot Availability Fee, and $24.00 Monthly Fee) for comparison to the Company's proposed rates. (Tr. at 33).

Mr. Gorman further testified the Company's letter of December 20, 1999, was apparently a continuation of a policy adopted by the BCC, Inc. Board of Directors in 1992 to cover the cost of expansion of the sewer system to Greenbrier Circle and at some point in the future to continue expansion of the system.[2] At the time, the Board approved a $7,500 sewer connection fee for connections made prior to August 1, 1992, and $10,000 after that date. Mr. Gorman testified the Company's letter of February 11, 2000, attempted to convert the sewer "Availability Fee" into a "Development Fee" for the entire project. He testified the developer is usually responsible for

[2] The letter states that the Company is offering the homeowner the opportunity to pay the "availability fee" for the development of his lot, which included the installation of a sewage lateral, at the old rate of $10,000 per lot. BCC Inc. had charged a $10,000 connection fee for several years to recover the cost of providing sewer service to Greenbrier Circle. *See*, Written comments of John Moore at Attachment A.9.

constructing the roads and associated infrastructure in the subdivision. The developer would recover these costs in the price of the lots he sells. Mr. Gorman is unaware of any precedent that would allow a developer to recover these costs retroactively from an incumbent property owner. Mr. Gorman testified the sales contract transferred the liability of the development costs as well as the assets (unsold lots and sewer system) to the Company. (Tr. at 34-35).[3]

On cross-examination, Mr. Gorman testified there was nothing written or inferred in the sales contract that permitted the Company to impose a development fee on the purchase of new lots. He testified the contingent liability to complete the development of the sewer system, roads, and other infrastructure improvements was $531,834 at the time of the sale, although Mr. Gorman did not know how much of that was needed to complete the sewer system. He further testified there was no clear statement in the contract whether the Company would continue the $10,000 sewer connection fee in effect at the time of the transfer. Mr. Gorman testified the costs for the sewer system extension for Greenbrier Circle were amortized among the property owners in the area to be served and the $7,500 and $10,000 sewer connection fees were established and collected by BCC, Inc. The sewer connection fees were specific to that portion of the development, and were used only to complete the sewer system to Greenbrier Circle; none of the fees were used for road construction. Finally, Mr. Gorman testified the Greenbrier Circle loan was taken out to complete the roads and sewer system in that portion of the subdivision. (Tr. at 36-44).

Mr. Flynn Auchey, a homeowner in BCC Estates, testified the Company's failure to timely complete the roads and sewer in the development added approximately $8,000 to $12,000 to the cost of his home. Although, he was ready to move into his house in November 1998, he was forced to wait until the sewer system was completed in February 1999. During installation of the sewer line near his house, the construction company encroached beyond the utility easement, destroyed trees in his yard, and failed to return the ground to its original grade. Mr. Auchey paid a $10,000 sewer connection fee to the Company around March 1, 1999. The Company told him the fee was to connect him to the sewer system. At the time he paid the fee, he was concerned with the lack of progress on the roads and other improvements in the subdivision. Mr. Auchey testified the Company still has not completed the roads in the subdivision, construction on the roads has been generally substandard, and the roads are already beginning to break apart. Mr. Auchey testified the sewer service has been adequate; however, there was one period during 1999 when a sewer lift station was inoperative for three to four weeks and there was raw sewage leaking out of it. Mr. Auchey neither favored, nor opposed, the Company's Application, but he offered his testimony of the past performance of the Company as an indicator of possible future performance. (Tr. at 45-51).

Mr. Patrick E. Devens, another homeowner in BCC Estates, testified that under the terms of the sales contract, the Company assumed responsibility for expansion of the sewer system to all new lots. The new lots are located on the opposite side of the development, and essentially made up a separate phase of the development. Mr. Devens testified the homeowners were told the transfer of ownership of the sewage treatment plant would have no impact on their rates. He testified the existing sewage treatment facilities were adequate to serve the entire subdivision as originally planned, and any development costs should be covered through the sale of the undeveloped lots. (Tr. at 54-56).

[3] *See*, Written comments of Joseph V. Gorman, Jr. dated July 31, 2000.

Mr. Devens argued the costs proposed by the Company are outrageous compared to sewer charges in other developments in the Roanoke Valley. He filed written comments wherein he provided an example showing that the Company's practice of including development costs in the service connection fee hides the true cost of lots from potential buyers. In his written comments, Mr. Devens also stated a new development in the area comparable to BCC Estates in terms of lot price is charging only a $1,000 sewer connection fee. (Tr. at 56-58). [4]

On cross-examination, Mr. Devens testified a number of the homeowners were upset when the Company suddenly increased its sewer rates from $29 to $34 a month. He further testified he purchased his lot a long time ago and paid a sewer connection fee of $3,000, to avoid the fee increase when BCC, Inc. increased the fee to $10,000. When he ultimately built his house, he paid no other connection fees. (Tr. at 59-68).

Mr. George Willard, a lot owner in BCC Estates, testified that he also prepaid a $3,000 sewer connection fee in 1993 or 1994, prior to it being raised to $10,000. He has not yet built on his lot, but he intends to pay no additional sewer connection fees. The home and lot owners were assured that a number of improvements were going to be made in the subdivision when the transfer to the Company occurred. Since the Company assumed the development responsibility, Mr. Willard has seen significant improvement in the roads around the subdivision. (Tr. at 70-71).

The Company offered the testimony of two witnesses in support of its Application. Mr. Daina Trimble Reynolds, II, provided an overview of the management, operation, and maintenance of the sewage treatment plant, and the Company's proposed rates and terms of service for its sewer service. Mr. Reynolds testified the Company and CSW Associates are sister companies that are jointly owned by two individuals. CSW Associates manages and operates the sewage treatment plant for the Company. Mr. Reynolds is the superintendent of the sewer system and the certified operator of the sewage treatment plant. The sewage treatment plant serves the Blacksburg Country Club and the homes in BCC Estates. The service territory contains 245 drawn lots (approximately 34 lots cannot be developed at this time) and 116 current customers. The plant is permitted for 39,5000 gallons per day discharge and it is currently operating at about one-third of its permitted capacity. The system is composed of a treatment plant with 50,000 gallons capacity, two gravity flow sewage pumping stations, two force main sewage pumping stations, and connecting mains and sewers. The plant is an extended aeration system with post-chlorination and dechlorination. (Ex. DR-2, at 3-4).

The Company is proposing a monthly rate of $34 for residential customers, a monthly availability fee of $20, a disconnect and reconnect charge of $5,000, and a bad check charge of $20. In its Application, the Company initially proposed a service connection fee of $17,500, but it reduced this fee to $3,500 in its prefiled testimony. In its rebuttal testimony, the Company reduced the connection fee to $2,500 and recharacterized it as a one-time capital contribution or contribution in aid of construction ("CIAC"). The Company collected a $10,000 "sewer connection fee" from each of six customers in 1999. This fee was used to defray the cost of the roads, sewer system, and other improvements in the subdivision. Mr. Reynolds testified it was referred to as a sewer connection fee because it was due at the time the home was connected to the sewer system. In the past, the sewer connection fee was due before construction on the home commenced. All of the

[4] *See*, Written comments of Patrick E. Devens dated October 18, 1999.

sewer connection fees collected by the Company have been applied to the Company's debts; however, there are a few sewer connection fees that are secured by notes that have not yet been paid. (Ex. DR-2, at 5-6; Tr. at 124-25, 134).

CSW currently charges the Company a management fee of $24,000 per year to cover the cost of Mr. Reynolds' time spent operating and maintaining the system. For this fee, the Company receives at least four hours of Mr. Reynolds' time each day. A significant portion of Mr. Reynolds' time is spent conducting the tests required by the system's operating permit and inspecting the sewage pumping stations. The Company obtained an estimate of $43,500 per year from Petrus Environmental to perform the same services. CSW also charges the Company a $4,000 per year fee for handling various accounting functions, such as billing and collections. (Ex. DR-2, at 6-7; Tr. at 120-21, 125-26).

During 1999, the Company made significant improvements to the sewage treatment plant and the remainder of the system. For the next year, the Company expects to make additional equipment purchases of $35,800, with the largest purchase being a wheeled generator. The Company has completed all required and recommended improvements suggested by the Virginia Department of Environmental Quality ("DEQ") and the sewer system is in compliance with all Virginia Department of Health ("VDH") regulations and guidelines. (Ex. DR-2, at 7-9).

In support of the Company's disconnection and reconnection charges, Mr. Reynolds explained that a discontinuation of service requires only that a contractor place a balloon valve in the lateral and inflate it, thereby stopping the flow of sewage from the house. A disconnection of service requires the removal of the entire lateral. The cost to reconnect service at a later date would be greater than the initial installation of the lateral because it is more cost efficient to install the lateral during initial construction. Mr. Reynolds testified the disconnection of service is included in the Company's tariff in the event a home is completely destroyed requiring the removal of the entire lateral. (Ex. DR-2, at 9; Tr. at 127).

In support of the Company's connection fee, Mr. Reynolds testified there are two aspects to making a connection. The first is installing the laterals. The Company installed all the laterals during the construction of the system. The lateral consists of a six-inch PVC pipe, a tee connection, and an exposed section of pipe with a cap showing the location of the lateral for the homebuilder. The second aspect is connecting the sewer discharge from the house to the lateral. The Company obtained a bid of $3,200 to make this connection. This cost does not include the cost of the lateral. The Company intends to use the sewer connection fee to pay off the debt incurred to upgrade the existing plant, and extend and upgrade the sewer system. (Ex. DR-2, at 9-10; Tr. at 138-39).

Mr. Reynolds explained that the Company created CCWWS in response to the Staff's concerns that the sewer operations should be separated from the Company's development operations. Unfortunately, DEQ would not transfer the Company's operating permits until the Commission certificated the Company. (Tr. at 110-11).

Mr. Reynolds also tried on direct and cross-examination to distinguish between the additions made by the Company and the systems already in place when the Company assumed operation of the sewer system. The Company constructed two new sewage pumping stations, a lab, a new one

and one-half inch and a new three-inch force main. Already in place when the Company acquired the sewer system, were two sewage pumping stations and sewer mains throughout portions of the subdivision. Even with the benefit of the transcript, it is impossible to determine with any degree of specificity which sewer main extensions were made by the Company, or which laterals were installed by the Company. (Ex. DR-3; Tr. at 109-110, 113-118, 137).

In his rebuttal, Mr. Reynolds provided additional testimony on the loans the Company and its principals took out to finance construction in the subdivision. Since the Company did not have a credit history, one of its principals borrowed $500,000 and loaned it to the Company for operating capital. In addition, this individual loaned approximately $159,000 in personal funds to the Company. After the Company established its creditworthiness, it borrowed an additional $425,000 from the Grundy National Bank. These loans were guaranteed by one of the Company's principals. The proceeds from these loans were used for construction throughout the subdivision, including improvements to the sewer plant and extensions of the sewer system. Mr. Reynolds testified approximately $482,839 (before any capitalized interest) was expended on the sewer utility. Finally, Mr. Reynolds requested that the Company be given at least 90 days to convert its books to the Uniform System of Accounts ("USOA") for Class "C" water utilities. (Ex. DR-14, at 1-2).

In his additional rebuttal, Mr. Reynolds responded to Mrs. Moore's testimony that the Company assumed BCC, Inc.'s obligation to construct roads, improve the sewer treatment plant, and expand the sewer system in return for the undeveloped lots that were transferred in the sales contract. Mr. Reynolds testified Mrs. Moore's claim was totally without merit. Mr. Reynolds believes Mrs. Moore failed to provide any support for her claim and she apparently misunderstands the sales contract. Mr. Reynolds argues the sales contract permits the Company to continue collecting a connection fee to cover part of its capital costs for the system. In addition, the contract permits the Company to charge a service fee to recover its operating expenses. Essentially, Mr. Reynolds argues Mrs. Moore has provided no proof that the Company agreed to make improvements to the sewer treatment plant and expand the sewer treatment system without some charge to the lot owners. (Ex. DR-15, at 1-4).

Mr. Reynolds also provided additional rebuttal testimony concerning the Company's installation of the sewer laterals and the cost to install those laterals. He testified Mr. Tufaro apparently misunderstood his direct testimony. The Company obtained estimates to install 25 and 30 feet of sewer lateral in support of its requested $2,500 connection fee. The 10-foot section of pipe discussed in Mr. Tufaro's testimony is connected to the clean-out to show the builder where the lateral ends; it is not the length of the lateral. The Company estimated the laterals are, on average, 25 feet in length. (Ex. DR-15, at 4-5).

Mr. Reynolds was unsure of the number of lots that were individually owned, and not served by the sewer system, at the time of the sale. The Company later provided a calculation showing 73 lots met these criteria. Of the 62 lots the Company assumed under the real estate sales contract, Mr. Reynolds testified 18 lots are in the flood plain and, at this time, it is cost prohibitive to develop those lots. The Company has sold 24 lots with an average selling price of $28,000. Twenty lots remain available for the Company to sell. At first, Mr. Reynolds testified "The Hill" was of little value. However, he agreed that, if 60 luxury townhomes were built on "The Hill" as envisioned in the sales contract, the land could be very valuable. To date, the Company has spent approximately

$1.6 million on the entire development. Mr. Reynolds estimated the Company spent approximately $400,000 on sewer improvements; $430,000 to build a bridge; and the remainder for roads and other infrastructure improvements. (Ex. DR-16; Tr. at 235-46; 248; 251-52).

Mr. Burnice C. Dooley testified on the reasonableness of the rates included in the Company's Application. For the test year, Mr. Dooley found the Company had operating revenues of $33,113, and operating expenses of $66,716, resulting in a net operating loss of $33,603. The Company posted a net loss for the year of $35,900. The Company's total rate base for the test year was $625,082. After certain adjustments were made, the Company had total operating revenues of $40,368, and total operating expenses of $85,685, which produced a net operating loss of $45,317 and a net loss of $94,815. After adjustment, the Company's total rate base was $582,317. [5] Even with the rate increase, Mr. Dooley opined the Company would continue to operate at a loss. (Ex. BD-4, at 1-4).

At the time the Company acquired the sewer system, the system had a rate base of zero. Mr. Dooley testified the Company continued the practice of collecting a $10,000 sewer connection fee. Mr. Dooley testified this charge was obviously designed to recoup more than just the cost of a sewer connection. It also included the costs of building the entire sewer system and the subdivision's roads.[6] Mr. Dooley testified the $17,500 connection fee initially proposed by the Company was designed to collect the cost of all sewer and road improvements. However, since the road portion could not be included in sewer rates, he calculated a more modest connection fee of $3,500 in his direct testimony. He arrived at this figure by dividing utility plant by the number of potential connections ($620,800 ÷ 175 = $3,547 ~ $3,500).[7] Mr. Dooley argued the recovery of the entire cost portion of the sewer system built by the Company, from customers who came on-line after the Company acquired the system, is necessary to ensure fair and equitable treatment of customers who were on the system when it was acquired. If future customers are not required to pay for the capital costs of the additional sewer system plant built to serve them, then existing customers will be required to pay sewer rates that include depreciation and a return on investment for plant built to serve future customers. (Ex. BD-4, at 5-6).

On cross-examination, Mr. Dooley testified the Company provided him the $628,757 for utility plant in service for the test year, which came from the Company's books. Mr. Dooley further testified he calculated the $28,000 he included as CIAC in his direct testimony by multiplying the connection fee by the number of fees collected in the test year ($3,500 x 8 = $28,000). Although the Company collected $10,000 per connection, Mr. Dooley allocated only $3,500 as CIAC for the sewer system.[8] (Tr. at 142-44; Ex. BD-4, at 3-4).

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[5] *See*, Exhibit BD-4, at 2-4; Exhibit BD-4, Schedule 1. It should be noted that Mr. Dooley's Schedule 1 contains an error in Column 4. Mr. Dooley failed to account for revenues generated by the Company's availability rate. As a result, both Columns 4 and 5 are incorrect. Mr. Dooley corrected this omission in the Rate of Return Statement included in his rebuttal testimony.

[6] Given Mr. Gorman's testimony, Mr. Dooley is incorrect in his statement that the connection fee collected by BCC, Inc. was used for road construction.

[7] In his rebuttal testimony, Mr. Dooley reduced the Company's proposed connection fee to $2,500.

[8] In his rebuttal, Mr. Dooley calculated his $20,000 in CIAC by multiplying the Company's newly proposed $2,500 connection fee by the number of fees collected in the test year ($2,500 x 8 = $20,000).

On rebuttal, Mr. Dooley addressed Mr. Armistead's disallowance of capitalized interest in calculating the Company's rate of return, and Mr. Tufaro's disallowance of a connection fee to recover any capital costs including the cost of connecting a customer to the system. Based on his calculations, Mr. Dooley believes the Company would need to increase its rates by 66% above the rates proposed in this case to break even. In support of restoring $33,239 of interest capitalized during construction to utility plant, Mr. Dooley argued the Commission has allowed capitalization of interest where the construction will serve new customers and is significant in relation to overall rate base. Mr. Dooley believes the costs related to the extension of sewer mains, sewage pumping stations, and laterals meet the Commission's criteria. (Ex. BD-12, at 1-2).

Mr. Dooley reduced his connection fee from $3,500 to $2,500 and recharacterized it as a one-time capital contribution or CIAC. This decrease is the result of the disallowance of certain costs in utility plant, the discovery that five lot owners had previously paid a connection fee, and the removal of the cost of improvements to the sewage treatment plant. Mr. Dooley testified the Company should be permitted to recover in the connection fee the cost of the laterals it installed during the construction of the sewer mains. It was more economical to install the lateral at the time of initial construction rather than come back at a later date and install the line. The connection fee would be included in rate base as CIAC; therefore, there would be no double recovery for the Company. The Company would not earn a return on funds supplied by its ratepayers. As CIAC is increased, the Company's rate base would decline. Mr. Dooley believes the Staff's position penalizes the Company for a business decision that ultimately saves the Company's future customers money. He further believes it is fair and equitable for future customers to make a contribution to capital, since existing customers have contributed capital for the sewer system that was built to serve them. Since the Company has already made the capital improvements, Mr. Dooley testified there would be no need for an escrow account because the Company is only trying to recoup costs it has already incurred. Mr. Dooley distinguished the *Land'Or* case.[9] In that case, the Commission required the utility to escrow the capital contributions because the Commission did not want the utility to use the money for operating expenses. In this case, the Company would use the funds to extinguish debt it incurred in making the capital improvements. Based on a $2,500 connection fee, Mr. Dooley argues the Company's CIAC should be $20,000, rather than $110,000 which was used by Mrs. Moore and Mr. Armistead. (Ex. BD-12, at 3-7; Ex. BD-13, at 1-3).

In his additional rebuttal, Mr. Dooley further addressed Mr. Tufaro's objection to the Company's estimate for the installation of the laterals. When the laterals were installed, a 10-foot section of pipe was left exposed to mark the end of the lateral and the location of the sewer clean-out. The estimates supplied by the two contractors included all of these costs. Mr. Dooley also pointed out that, in his denial of the connection fee, Mr. Tufaro failed to address the fairness issue. Essentially, it is unfair to require existing customers to pay the cost, in the form of higher rates, of extending the sewer system for new customers. Mr. Dooley explained again how the Company, if it collected a connection fee, is not recovering the cost of a sewer connection twice. The sewer connection fee would be recorded on the Company's books as a CIAC. Mr. Dooley also responded to Mrs. Moore's recommendation that the sewer system should be removed from rate base. Mr. Dooley testified the entire sewer collection system that is used and useful in the rendition of utility service should be included in rate base. As sewer connection fees are collected, the fees would be recorded as CIAC, offsetting the cost of the system in rate base. Mr. Dooley failed to address Mrs.

[9] *SCC v. Land'Or Utility Company, Inc.*, Case No. PUE940081, 1995 S.C.C. Ann. Rep. 336.

Moore's fundamental argument that the proceeds from the undeveloped lots that were transferred to the Company should have been recorded as CIAC to offset the cost of expanding the system, which results in a zero, or slightly negative, rate base. (Ex. BD-13, at 1-4).

On further cross-examination, Mr. Dooley accepted Mr. Armistead's $482,840 for utility plant in service. However, Mr. Dooley disagreed with Mr. Armistead's treatment of the $42,000 in debt the Company assumed at the time it acquired the sewer system. Mr. Armistead credited three payments of the $10,000 sewer connection fee collected by the Company to CIAC. (Tr. 219-21).

Mr. Dooley did not independently verify the payments shown on his Schedule 2, which were used to develop his capitalized interest expense. Mr. Dooley relied on the Company's accountant and Mr. Reynolds to separate the expenses based on whether they were for the sewer treatment plant or for the sewer collection system. (Tr. at 223).

The Staff offered the testimony of two witnesses. Mr. Ashley W. Armistead, Jr. testified on the accounting issues. He spent two weeks auditing the Company's books, including revenues, expenses, taxes, and balance sheet accounts. Mr. Armistead testified the Company maintains its records on a cash basis. The Company maintains a check disbursement journal, an invoice file, and bank statements to document the utility's revenues and expenditures from its bank account in Roanoke, Virginia. The Company also maintains an invoice file to support disbursements made from its Grundy, Virginia bank account. Mr. Armistead found the Company's general ledger was not maintained in accordance with the USOA for Class "C" wastewater utilities as required by the Commission's Rules Implementing the Small Water or Sewer Public Utility Act. Mr. Armistead recommended that the Commission direct the Company to establish its books in accordance with the USOA, and that the Company be given 90 days to make this transition. (Ex. AA-5, at 1-4).

Mr. Armistead made a number of adjustments to arrive at the Staff's recommended revenue requirement of $70,128; an adjusted operating income of $3,905; and a 1.07% return on rate base of $364,842. In his adjustments, Mr. Armistead: (1) annualized the Company's revenues for its residential and availability customers; (2) removed non-recurring costs from the Company's cost of service; (3) removed costs that occurred prior to the test year; (4) increased cost of service for costs incurred in the test year, but not booked until the following year; (5) capitalized certain expenses that the Company had expensed; (6) eliminated a duplicate payment on one invoice; (7) eliminated bad debt expense; (8) reduced management fee expense to the amount paid by the Company; (9) annualized the Company's electric expense for the treatment plant and pumping stations; (10) annualized the premium on two insurance policies covering the sewer system; (11) amortized the expense of this rate case over five years; (12) allowed a 3% composite rate for depreciation; (13) included the property tax for the sewer system's land and building; (14) included one-ninth the adjusted operations and maintenance expenses in rate base as cash working capital; (15) included various costs in utility plant that were expensed during the test year; and (16) computed depreciation expense based on a 3% composite rate. (Ex. AA-5, at 4-11; Ex. AA-6; Ex. AA-7).

Mr. Armistead did not allow the Company any interest expense in his rate of return calculation. He determined that the sewer utility did not have an actual note or a loan payable, therefore, he did not compute interest expense. In addition, he found that the Company has no

direct federal or state tax liability since the Company chose to file as part of a partnership. (Ex. AA-5, at 4, 9-10).

Mr. Armistead prepared an amended Rate of Return Statement showing the effect of the Company's collection of the $10,000 sewer connection fee from 11 homeowners since it took over the operation of the sewer system. He characterized this fee as a capital contribution and accounted for it as CIAC. The capital contributions had the effect of reducing the Company's total net utility plant from $463,326 to $358,726. To calculate adjusted utility plant in service of $482,840, Mr. Armistead verified with the Company's suppliers and contractors amounts spent on the sewer system. (Ex. AA-7; Tr. at 149, 159-60).[10]

On cross-examination, Mr. Armistead confirmed that he gave no consideration to the provisions of the sales contract when he prepared his testimony. He included the entire $10,000 sewer connection fee in his calculations and made no deductions, because the Company collected the money as a connection fee and it is irrelevant where it ultimately used the money. Mr. Armistead agreed that his 1.07 percent return on rate base was rather small and there was very little margin to cover unforeseen expenses. Mr. Armistead was aware of the three notes that the Company and one of its principals had taken out to fund the combined real estate and sewer system development; however, he did not include capitalized interest in his calculations because none of the notes were in the name of the sewage utility. Mr. Armistead is aware of one gas company that has been allowed to capitalize interest, but he is not aware of any water or sewer company that has been permitted to capitalize interest. Mr. Armistead's denial of capitalized interest had a $33,000 impact on the Company's rate base. (Tr. at 150-58).

Mr. Marc A. Tufaro provided the Staff's testimony on the Company's request for a CPCN, including the Company's proposed rates, rules, regulations, and quality of service. He recommended: (1) a $34 per month unmetered residential sewage rate and a $20 availability rate; (2) the Company's request for a commercial usage rate be denied because it was not included in the Company's filed Application, and that revenues in the amount of $134 per month be imputed to the Company for supplying sewage service to the Blacksburg Country Club; (3) a late payment fee of 1½ percent per month on all past due balances; (4) a customer deposit equal to the customer's estimated liability for two months' usage; (5) a bad check charge of $20; (6) no connection fee or one-time contribution to capital; (7) a turn-on charge of $25 to restore sewer service discontinued for non-payment of a bill, violation of the Company's tariff, or at the request of the customer; (8) no disconnect charge or reconnect charge; (9) modification to Rule No. 11 – Abatements and Refunds of the Company's tariff to reflect that the Company does not provide water service; and (10) the Commission grant the Company a CPCN. (Ex. MT- 8, at 16).

There are only two areas of dispute between Mr. Tufaro and the Company. The first is the Company's proposed sewer connection fee. Mr. Tufaro testified the only cost data submitted by the Company was an estimate for connecting a sewer discharge line from a house to the lateral installed

[10] Mr. Dooley and Mr. Armistead accounted for CIAC quite differently. Mr. Dooley allocated $2,500 of the $10,000 connection fee collected by the Company to its sewer operations. In addition, Mr. Dooley included only the eight sewer connections made during the test year to arrive at his CIAC of $20,000 in his rebuttal testimony. On the other hand, Mr. Armistead included the entire connection fee collected since the inception of the Company's sewer operations to arrive at his CIAC of $110,000.

by the Company. This cost is generally borne by the homeowner, and is not included in the Company's rate base. The Staff has consistently recommended connection fees that are an average of the actual cost of connecting to a utility's system. In this case, however, the Company has already installed the laterals. The costs are included in rate base and the Company is earning a return on those costs. Since the Company is incurring no cost to make the connection, the connection fee is entirely a capital contribution. The Staff is also opposed to the sewer connection fee even if it is characterized as a one-time capital contribution or CIAC. The Company failed to meet the requirements established by the Commission in *SCC v. Land'Or Utility Company*, Case No. PUE940081, 1995 S.C.C. Ann. Rep. 336, to collect connection fees in excess of the actual cost of the connection. The Company failed to present any evidence of its need to expand the sewer plant to meet the needs of future customers. Mr. Tufaro argues to assign the entire cost of the original plant in service to future customers would be inequitable. (Ex. MT-8, at 10-13; Ex. MT-9).

The second area of disagreement is the Company's proposed $5,000 disconnect and reconnect fee. Mr. Tufaro testified the Company failed to present any testimony justifying a need to completely remove and then reinstall a lateral serving a home. He testified both of the charges would be punitive, and he is concerned how the Company would apply the charges. (Ex. MT-8, at 14).

On cross-examination, Mr. Tufaro testified the Commission could not order a refund of sewer connection fees collected by the Company prior to the date the Application was filed in this case. The additional $110,000 of CIAC in Mr. Armistead's Amended Rate of Return Statement had no impact on the Company's $70,128 revenue requirement. Mr. Tufaro testified one of his other concerns with the Company's proposed $2,500 capital contribution or CIAC is the consequence to ratepayers if the Commission adopts the Protestant's position that the lots conveyed to the Company were a contribution to cover the cost of extending the system. If these contributions are factored in, the collection of a $2,500 capital contribution or CIAC may cause the Company to have a negative rate base. Mr. Tufaro expressed his concern that, if the Company had a negative rate base, the $2,500 capital contribution or CIAC would go directly to the Company with no corresponding impact on the customers' rates. Mr. Tufaro does not disagree with Mr. Dooley's analysis, in his rebuttal testimony, that there would be no double recovery in this case. As of the date of his testimony, Mr. Tufaro was not concerned with the Company possibly overearning if it collected a capital contribution. Mr. Tufaro agreed that it was more cost-effective to install the laterals at the time the mains were installed. Mr. Tufaro is aware of a utility's obligation to serve. He testified that obligation does not require it to build facilities for free or provide utility service for free. (Tr. at 164-73).

Protestant Mrs. Moore testified she is concerned that the accounting treatment given in the prefiled testimony is inappropriate and, if adopted, could result in sharp increases in monthly service fees for several years. She is also concerned that inaccurate and incomplete information could result in additional future hearings, which may be both costly and time consuming. (Ex. JM-10, at 1).

Mrs. Moore testified BCC Estates was originally platted in 1969 with 242 lots. She provided background information from old sales contracts and the Montgomery County Land Subdivision Ordinance showing that it is the developer's responsibility to construct roads and these

costs are recovered through the sale of lots, not through sewer connection fees. Mrs. Moore included a copy of the sales contract between BCC, Inc. and the Company in her testimony. She considers the contract vital to this case. She testified that in return for certain consideration (the conveyance of the sewer treatment plant and associated infrastructure, the 62 lots, the 10 acres known as "The Hill," and 5 acres of land fronting on Route 723) the Company agreed in Section 2 (Purchase Price) of the contract to: (A) pay off the outstanding balance of $41,957.22 on BCC, Inc.'s construction for the Greenbrier Circle development; (B) build or upgrade the roads in the subdivision to VDOT standards; (C) complete sanitary sewer service to the property line of all (but four) individually owned lots; and (D) generally assume all of BCC, Inc.'s real estate development and operations obligations not enumerated above in regard to all phases of the subdivision. (Ex. JM-10, at 1-3).

Mrs. Moore testified the Company, in order to satisfy Paragraph (C) of Purchase Price, needed to construct two sewage pumping stations, sewer mains, and laterals for 35 lots. At the same time, the Company has chosen to complete the sewer system to 31 of the lots it received from BCC, Inc. Mrs. Moore believes the cost to extend the sewer system to serve these lots is covered under Paragraph (D) of Purchase Price. Based on the Company's total construction costs for the sewer system of $382,878, Mrs. Moore calculated that $202,130 of the sewer addition costs are covered under Paragraph (C) of Purchase Price, and another $180,758 of the sewer addition costs are covered under Paragraph (D) of Purchase Price. Mrs. Moore testified the Company's utility plant shown in Mr. Armistead's Statement II, Column 3 of $482,840 should be reduced by $383,959 because the Company recovered the cost to extend the system in the undeveloped lots it was given as consideration in the real estate sales contract. (Ex. JM-10, at 4; Schedule JGM.k).

Mrs. Moore testified the Montgomery County deed book shows the Company has sold 22 of the 62 lots it acquired. She argued that assuming an average sale price of $40,000 for the lots, the Company has more than recovered the cost for the sewer extensions. Mrs. Moore provided a detailed analysis of the status of sewer service to all 242 lots in the subdivision, and whether a sewer connection fee had been paid. She further testified the Company would recover enough from the sale of the 62 lots to meet its obligations under the real estate sales contract. (Ex. JM-10, at 5-6; Schedule JGM.i).

Mrs. Moore testified changes should be made in the rate of return statements included in the prefiled testimony to omit the expenses for the sewer system since these expenses are accounted for as part of the Purchase Price in the real estate sales contract. She testified CIAC needs to be adjusted to account for all the sewer connection fees recorded by the Company. In addition, amortization of CIAC needs to be included. Mrs. Moore made these adjustments in her Schedules JGM.k. (Ex. JM-10, at 7; Schedules JGM.k1, k2, and k3).

Mrs. Moore favors continuing the sewer connection fee as a one-time capital contribution or CIAC. At the time of the hearing, sewer connection fees had been paid on over half the lots in the subdivision. In fairness to the homeowners and lot owners who have already made a capital contribution or CIAC for the sewer system, Mrs. Moore testified that the sewer connection fee should be continued. She also testified the sales contract limits the rates that may be charged for sewer service. The rates are tied to the rates charged by municipal systems in the area. According

to Mrs. Moore, this was done so the system would operate as a non-profit system. (Ex. JM-10, at 8; Tr. at 189).

Finally, Mrs. Moore proposed amending Rule No. 17 in the Company's tariff to read that the cost for extending the sewer system, including the mains, is the responsibility of the developer. (Ex. JM-10, at 8).

On cross-examination, Mrs. Moore testified that according to the sales contract, the Commission could not approve a sewer rate higher than the prevailing rate in the community unless the Company proved that its costs, without a profit, justified the higher rate. Mrs. Moore hopes the Commission takes the sales contract into consideration, and that the Commission reaches a final decision consistent with the contract. She believes the contract is the only protection the homeowners have against the Company infringing on their rights. (Tr. at 191-193).

Under further cross-examination, Mrs. Moore clarified the basis for the sales price she used in her testimony. She obtained the $40,000 sales price from Mr. Reynolds. Apparently, Mr. Reynolds told her the Company was selling the lots it acquired to builders for that price, plus the $10,000 sewer connection fee, and taking back a note for $50,000. She has also seen lots in the subdivision priced at $50,000. Mrs. Moore explained how she arrived at her negative $3,721 rate base. She could not explain why the contract contained a provision for the Company to continue collecting a connection fee, if the sewer system extensions were to be paid out of the proceeds of the lots that were transferred. However, Mrs. Moore still believes it is important for the Company to collect a capital contribution or CIAC to meet its future expenses. She considers the $2,500 one-time capital contribution or CIAC to be very reasonable. In her opinion, this would keep the Company's rate base near zero so that the system could ultimately be turned over to the Montgomery County Public Service Authority. Mrs. Moore is not opposed to the Company's Application for a CPCN; however, she would prefer that the system be taken over by the Montgomery County Public Service Authority. She does not oppose the $34 residential service fee, unless it is found that it should be reduced to $33.95. Finally, she questions whether the Company's availability fee is enforceable, but she has no objection to including it in the Company's rates. (Tr. at 199-212).

DISCUSSION

This case involves a small sewage utility located in Montgomery County, just outside Blacksburg, Virginia. Ordinarily, an application for a CPCN to operate a sewage utility would be a routine matter for the Commission. However, this case is complicated by the fact that this utility has been operating illegally in Virginia since at least 1984. At that time, the utility surpassed 50 customers and it should have applied to the Commission for a CPCN. Further complicating the case is the fact that BCC, Inc., the original owner and operator of the sewage utility and the entity originally responsible for obtaining a CPCN, transferred ownership of the utility to the Company in 1995. The Company was unaware of the requirement to obtain a CPCN until the Staff contacted it in June 1999.

There are three major issues in dispute between the parties. The first is whether the Company should be allowed to include capitalized interest in its rate base. The second issue involves determining the Company's utility plant in service for ratemaking purposes. The third issue is whether the Company should be permitted to collect a one-time capital contribution or CIAC on new sewer connections. The resolution of the second and third issues may depend on whether the Commission has the authority to review the terms of the sales contract that transferred ownership of the utility to the Company.

Certificate of Public Convenience and Necessity

Although there are contested issues in this case, it is important not to lose sight of the fact that the overriding issue in this case is whether the Commission should grant the Company a CPCN to operate a sewage utility. The Company argues the public convenience and necessity justifies the issuance of a CPCN to the Company. In support of its argument, the Company cited the requirements set forth by the Virginia Supreme Court in *Virginia Gas Distribution Corp. v. Washington Gas Light Co.*, 201 Va. 370, 377, 111 S.E.2d 439, 444 (1959) for determining the public interest.[11] The Company argues that it meets these requirements. The Staff's position is the evidence in the record supports the issuance of the requested CPCN. The Protestant does not know whether the Company should be issued a CPCN. She believes the Company is ill-suited to own a public utility; however, she also believes that denying the Company a CPCN may leave its customers in a far worse position.

The evidence in the record supports the issuance of a CPCN to the Company to operate a sewage utility. The Company has made significant capital improvements to the system in order to improve its operational efficiency. The Staff found the overall appearance and operation of the system impressive. In addition, the regional DEQ office praised the Company's operation of the system. It appears from the record that the Company is providing adequate sewage service within its service territory at fair and reasonable rates. I find the public interest would be served if the Company were issued a CPCN. A CPCN will allow the Commission increased regulatory oversight of this utility, and enable the Commission to better protect the interests of the Company's customers. I recommend that the Commission issue the Company a CPCN to operate a sewage utility.

Accounting Issues

Mr. Armistead calculated a total revenue requirement for the Company of $70,128. This includes revenue generated by the Company's unmetered residential customers and the Company's availability customers. Mr. Armistead based his calculation on a $34 per month residential rate and

[11] The factors to be considered are: the rates in relation to the relative value received; the area involved; the ability of the utility to serve the area under normal and emergency conditions; the different types of service rendered; and the character of the service rendered. (*Id.* at 377).

a $20 per month availability rate. The Company accepted Mr. Armistead's total revenue requirement calculation.[12]

The standard for establishing rates for sewer utilities is set forth in Section 56-265.13:4 of the Code of Virginia. This statute provides, in part, that:

> The charges made by any small water or sewer utility for any service rendered shall be (i) uniform as to all persons or corporations using such service under like conditions and (ii) nondiscriminatory, reasonable and just. Every charge for service found to be otherwise shall be unlawful. Reasonable and just charges for service within the meaning of this section shall be the lowest charges as shall produce sufficient revenues to pay all lawful and necessary expenses incident to:
>
> 1. The operation of the system, including maintenance costs, operating charges, and interest charges on bonds or other obligations;
> 2. The providing for the liquidation of bonds or other evidence of indebtedness and the attraction of capital;
>
> . . . .
>
> 5. Compensation of owners of the utility for their capital or property invested in the system, if any, and for their time and other resources expended in the operation of the system not otherwise recovered under subdivisions 1 through 4 of this section.

Applying the standards set forth above, I find the Company's adjusted total revenue requirement of $71,760 to be reasonable. The revenue requirement will permit the Company to earn a positive return on rate base, albeit a small positive return. I recommend that the Commission approve the Company's $71,760 revenue requirement.

The Company included $33,239 of capitalized interest in its rate base. Mr. Armistead disallowed the capitalized interest because none of the loans used for improvements to the sewer system were in the name of the utility. In response, the Company submitted evidence of one outstanding note in the name of one of its principals and two outstanding notes in the name of the Company. (*See*, Attachments to Ex. DR-14). In rebuttal testimony, Mr. Reynolds testified that it was necessary for one of the Company's principals to personally borrow money and loan it to the Company for operating capital. At the time this was done, the Company had no credit history and could not borrow money in its own name. (*See*, Ex. DR-14, at 1-2). The borrowed funds were used for improvements to the sewer system, the sewer plant, roads, and other infrastructure improvements in the subdivision. The Company provided an exhibit showing what funds were used for sewer construction, and how those funds were allocated between the sewer collection system and the sewer treatment plant. (*See*, Rebuttal Schedule 2, Ex. BD-12). The capitalized interest included in the Company's rate base calculation relates solely to funds borrowed for improvements to the sewer collection system.

[12] In his total revenue requirement calculation, Mr. Armistead did not include the $136 per month in revenues the Commission should impute to the Company for agreeing to provide free sewage service to the Blacksburg Country Club. The addition of these revenues increases the Company's total revenue requirement to $71,760. (*See*, Page 29 of this Report).

The Company argues the Commission has allowed capitalized interest where utility construction is to serve new customers and is significant in relation to overall rate base. In support of its argument, the Company cites *Application of Virginia Gas Distribution Co.*, Case No. PUE990531, Final Order (Feb. 22, 2000) and *Application of Virginia Natural Gas, Inc.*, Case No. PUE900028, 1991 S.C.C. Ann. Rep. 292, 294, Order Amended, 1991 S.C.C. Ann. Rep. 297.[13] The Company argues that its costs relating to the extension of sewer mains, sewage pumping stations, and laterals meet the criteria established by the Commission.

The Staff and the Protestant oppose the inclusion of capitalized interest in the Company's rate base. The Staff argues there are no loans or notes payable in the name of the sewer utility, therefore, the utility should not be entitled to an interest expense or capitalized interest. The Protestant argues there is nothing to indicate that any of the three notes the Company submitted into evidence had anything to do with the sewer system. Therefore, the Company should not be entitled to either interest expense or capitalized interest.

It is axiomatic that the Company had to use borrowed funds to undertake the improvements to the sewer system. The Company was organized specifically to undertake the development of the subdivision, including the operation and expansion of the sewer system. At the time of its organization, the Company had no working capital and no access to credit. The evidence is unrefuted that one of the Company's principals borrowed $500,000, in his own name, and loaned the money to the Company for operating capital. In addition, the same individual loaned approximately $159,000 of his own funds to the Company. After the Company established its creditworthiness, it borrowed an additional $425,000. The proceeds from these loans were used on infrastructure improvements throughout the subdivision, including improvements to the sewer treatment plant and sewer collection system. Mr. Reynolds testified approximately $482,839 (before any capitalized interest) was expended on improvements to the sewer system, including $382,878 on improvements to the sewer collection system.

The Staff and Protestant's positions place form over substance and unfairly penalize the Company. There is no separately incorporated or organized sewer utility in this case. There is only one limited liability company, which is engaged in two separate businesses at one time, developing residential real estate and operating a sewer utility. The Company allocated the funds it borrowed between its real estate operations and its utility operations, and computed $33,239 of interest capitalized during construction of the improvements to the sewer collection system. Neither the Staff nor the Protestant rebutted the Company's evidence on this issue.

On this record, I find that the Company used borrowed funds to make significant capital improvements to the sewer collection system for the benefit of new customers. The Company installed new sewer mains and laterals and constructed two new sewage pumping stations in order to serve new customers. I find the Company should be permitted to include the interest that accrued during the construction of these improvements, in rate base as capitalized interest. However, I disagree with the methodology used by the Company to compute capitalized interest. The Company used an interest rate of 9.5 percent on all three loans to arrive at its capitalized interest

[13] In Case No. PUE990531, the Staff and Virginia Gas Distribution Company agreed to a stipulation that included capitalized interest in rate base. The Hearing Examiner recommended that the Commission adopt the stipulation. In its final order, the Commission adopted the stipulation without modification.

number of $33,239. The interest rate on the three loans was tied to the prime lending rate and varied from a high of 9.5 percent to a low of 7.75 percent. On the attached Hearing Examiner's Worksheet 2, I calculated the capitalized interest on the sewer collection system additions using the prime lending rate in effect at the time the additions were made. This resulted in capitalized interest of $23,259, which I believe more accurately reflects the total interest which the Company incurred on the three loans and should be permitted to capitalize. I recommend that the Commission allow the Company $23,259 in capitalized interest in its rate base.

Two issues must be decided to determine the Company's rate base for ratemaking purposes: utility plant in service and contributions in aid of construction. The Company accepted the Staff's utility plant in service of $482,840. The only disagreement involved whether capitalized interest should be included in utility plant in service. As I have recommended in this Report, capitalized interest should be included in the Company's utility plant in service. As a consequence of adding capitalized interest, the Company's accumulated depreciation and depreciation expense must be adjusted. Those adjustments are shown on Hearing Examiner Statement 1, and are supported by Hearing Examiner's Worksheet 1, attached hereto.

The most contentious issue among the parties involves contributions in aid of construction. There are two subcomponents to this issue. The first is the proper accounting for sewer connection fees collected by the Company since it acquired the utility. The second is whether some, all, or none of the proceeds from the sale of the lots transferred to the Company under the sales contract should be included in rate base as CIAC.

The Company and the Staff accounted for connection fees quite differently. The Company allocated a portion of the $10,000 sewer connection fee it collected from lot owners to the sewer operations. Initially, this amount was $3,500, but the Company later reduced the amount to $2,500. The Company then multiplied $2,500 by the eight sewer connection fees collected in the test year to arrive at its CIAC of $20,000. The Company admits that it used the difference in the amount it collected as a sewer connection fee on other infrastructure improvements in the subdivision, such as road and bridge construction. The Company's accounting witness testified the Company was only continuing a practice that was begun by the utility's previous owner.

The Staff arrived at its $110,000 CIAC by multiplying the $10,000 sewer connection fee collected from lot owners by the eleven connection fees collected by the Company since it acquired the utility in 1995.

The Company argues the Staff's calculation is inaccurate because it fails to recognize the assumption of the $42,000 construction loan acquired from BCC, Inc. The Company states that three of the $10,000 sewer connection fees collected by the Company were used to extinguish this debt. The Company further argues the Staff failed to allocate the connection fee between the sewer system improvements and the other infrastructure improvements. The Company believes its $20,000 CIAC number is more appropriate.

The Staff strongly disagrees with the Company's allocation of the sewer connection fee between utility and non-utility capital improvements, arguing it is improper for a utility to withhold utility service to force a customer to pay non-utility expenses. The Staff argues the connection fees

were not imposed on customers to connect their driveways to the subdivision's roads. The connection fees were imposed on the customer to allow them to connect to the sewer system. The Staff argues that no portion of the sewer connection fee should be allocated to non-utility construction. The Staff further argues the Commission should reject the notion that $30,000 in sewer connection fees could be used to retire the debt the Company acquired from BCC, Inc. The Staff argues the use of capital contributions for repayment of acquisition expenses has no precedent.

The Protestant argues the Company's use of sewer connection fees to pay for roads and other non-sewer related expenses was deceitful and probably fraudulent. The Protestant argues the Company should be required to include the entire $110,000 it collected in sewer connection fees as CIAC.

I agree with the Staff and the Protestant that the entire $110,000 in sewer connection fees collected by the Company should be accounted for as CIAC. There is no support in the record that the Company was somehow entitled to use sewer connection fees for non-utility purposes. The Company's argument that it was merely continuing a practice begun by BCC, Inc. is without merit. The evidence in the record shows that BCC, Inc. computed its $10,000 sewer connection fee by amortizing the cost of the sewer extension for the Greenbrier Circle portion of the development among the potential customers to be served. The evidence further shows that BCC, Inc. used sewer connection fees only to cover the cost of extending the sewer system to serve Greenbrier Circle. None of the fees were used for road construction or other infrastructure improvements. The Company's reliance on BCC, Inc.'s past practice in support of its use of the sewer connection for non-utility infrastructure improvements is misplaced. As observed by one of the public witnesses, the Company's practice of using sewer connection fees for non-utility improvements appears to be nothing but a backdoor attempt to recover development costs that should have been included in the cost of the lot. At the time construction is completed on a new home, homeowners have no option but to pay whatever sewer connection fee is demanded by the Company, otherwise they could never occupy their new home.

I likewise agree with the Staff that there should be no offset for the $30,000 in sewer connection fees used to pay off the Greenbrier Circle construction loan. There is no evidence in the record that any of the outstanding balance on this loan related to the extension of the sewer system to serve this section of the subdivision. On the contrary, the evidence indicates that the costs for extending the sewer system would have been fully recovered in connection fees. On this record, it is just as likely that the outstanding balance on the loan related to the construction of roads and other infrastructure improvements for this section of the subdivision. The evidence supports this conclusion. The sales contract provided that proceeds from a pending lot sale were to be used to curtail this debt, with the remaining balance to be paid by the Company at settlement. On this record, I find the Company impermissibly used sewer connection fees to pay off a construction loan that was not utility related. I recommend that the Commission include the entire $110,000 in sewer connection fees collected by the Company in its rate base as CIAC.

At this juncture, the sales contract entered into between BCC, Inc. and the Company, and its impact on the present case should be addressed. The Protestant is claiming that the Company has already been paid, in the form of the undeveloped lots transferred under the sales contract, for extending the sewer system. She argues the Company cannot collect these costs again from

ratepayers. The Company argues the Protestant's claims relate to a private contract matter beyond the jurisdiction of the Commission. In support of its argument, the Company cites *Appalachian Power Co. v. Walker*, 214 Va. 524, 533-34, 201 S.E. 2d 758, 766 (1974) where the Court stated: "Nothing is better settled than that this Commission does not have jurisdiction to adjudicate and determine private rights or private contracts between public service corporations and individuals."[14]

The Company also relies on the Commission's decision in *Application of Lake Monticello Service Co*., Case No. PUE820054, 1983 S.C.C. Ann. Rep. at 369. In that case, the Commission adopted the Hearing Examiner's findings that the utility company could use connection fees to construct a central water and sewer plant, but that the utility could not use connection fees for normal operating expenses. In his report, the Hearing Examiner framed the issue as one whether "it was improper for the [utility] to use connection fees to build the central water and sewerage treatment systems, inasmuch as this was an obligation of the developer which had been factored into the price of the lots." Report of Stewart E. Farrar, Hearing Examiner, at 6, May 3, 1983. The Hearing Examiner recognized that "[t]he parties to this controversy may have a matter of private contract law to be settled here. The Commission, naturally, has no jurisdiction over this subject, and must leave the resolution of any such dispute to another forum." (*Id*. at 7).[15]

Finally, the Company argues the Protestant admitted on cross-examination that her intention in this proceeding was to see the Commission enforce the real estate sales contract. On cross-examination, the Protestant stated: "I would like the contract to be upheld, because I think it's the only protection we homeowners – it's the best protection the homeowners have against

[14] This case involved a breach of contract action. A contractor filed a petition before the Commission to enforce an oral contract between the contractor and Appalachian Power Company ("APCO") to install underground utility lines free of charge in a subdivision under development. The Commission denied the contractor's requested relief on the merits. The contractor then brought a breach of contract action in the Circuit Court of the City of Lynchburg. APCO filed a plea challenging the Circuit Court's jurisdiction on the ground the Commission had exclusive jurisdiction, a plea of *res judicata*, and a plea of illegality that the contract sought to be enforced was illegal under a Commission order prohibiting public utilities from offering the free installation of underground utility lines. The Circuit Court denied the various pleas and a jury awarded the contractor damages for breach of contract. APCO appealed the decision to the Virginia Supreme Court. The Virginia Supreme Court held that "the Commission had no constitutional or statutory jurisdiction to adjudicate [the contractor's] common law claim against [APCO]." (*Id*. at 534).

[15] This case involved a request for a rate increase by Lake Monticello Service Company (the "Service Company"). The Service Company was a wholly owned subsidiary of Monticello Development Company (the "Development Company"). The Service Company was formed to own and operate the central water and sewer treatment plants at the Lake Monticello development in Fluvanna County. The Homeowners' Association (the "Association") complained of the way the connection fees collected from lot owners had been used throughout the years. The Association argued that when the homeowners purchased their lots they paid for a number of amenities including a complete water and sewer system. In this case, the Development Company installed all the sewer mains and distribution lines, but did not construct the central water and sewer treatment plants. The Service Company spent $800,000 in sewer connection fees to construct these plants. The Association argued, had the Development Company not defaulted on its obligation to construct the plants, there would have been no need for a rate increase because the interest that would have been earned on the connection fees that were improperly used for construction of these plants would have offset any need for a rate increase. The Hearing Examiner was faced with several key pieces of evidence, including several HUD land reports and a promissory note signed by many of the lot purchasers. These documents indicated that, for a "one-time" water and sewer charge, the purchaser was entitled to a fully functioning water and sewer treatment system up to the boundary line of their property. The Hearing Examiner found "insufficient reason, in the ratemaking context, to recommend any action adverse to the [Service] Company by virtue of its use of certain portions of the connection fees for the capital improvement purposes described above." (*Id*. at 8).

infringements of our rights from [the Company]." (Tr. at 193). The Company argues the Commission should reject the Protestant's claims on this legal basis alone.

The Staff argues the sales contract has no impact on the rates in this proceeding. It does, however, argue the issue needs to be resolved in order to establish the Company's rate base for future proceedings. The Staff argues the plain terms of the contract obligate the Company to use a portion of the proceeds from the sale of the lots it received to extend the sewer system to individually owned, but not yet served lots. It calculated that approximately two-thirds of the cost to extend the sewer system went to extending the system to serve individually owned lots, and one-third went to extending the system to the Company's lots. The Staff noted the record was not well developed as to what costs were actually incurred to make the system extensions. It made its calculation based on an allocation of the costs between the individually owned lots and the Company owned lots.

The Staff further argues the Company failed to articulate a cohesive theory why the lots received in the sales contract should not be considered CIAC. The Staff considers it a valuable asset received as consideration for utility plant expansion. Without the receipt of the real estate, the Company was under no obligation to extend the sewer system. The Staff believes it is incumbent on the Company to demonstrate why the real estate it received in the sales contract should not be considered CIAC.

The Protestant argues the sales contract is an integral part of this case. She believes a fair and equitable decision cannot be reached in this case without consulting the contract's provisions. If the Commission should ignore the contract, the Protestant believes the result would be a double payment to the Company. The Company would receive the undeveloped lots as consideration for extending the system to serve individually owned lots, and it would also be able to recover the costs in rates, if the costs were still included in rate base.

The Protestant further argues the sales contract is the best evidence of the intention of the parties. She argues in favor of interpreting the entire contract. She argues the Company has interpreted bits and pieces of the contract out of context. She favors reconciling all of the provisions of the contract to reach its intended meaning.

In examining this issue it is important to remember what this case is and is not. This is a case involving an application. The Company has filed a written request with "the Commission for some right, privilege, authority or determination subject to the jurisdiction of the Commission. . . ." (Rule 4:2 of the Commission's Rules of Practice and Procedure). In deciding applications, the Commission acts in its legislative, rather than its judicial, capacity. As a consequence, the evidentiary rules in this proceeding are less strict. This case is not a common law contract action seeking specific performance of the contract between BCC, Inc. and the Company. For this reason, the *Appalachian Power Co. v. Walker* case cited by the Company is inapposite. Neither the Protestant, nor the Staff, has filed any pleading in this case seeking specific performance of the contract between BCC, Inc. and the Company. Both of these parties have argued that, for ratemaking purposes, the Commission may interpret the contract to determine the Company's proper rate base for ratemaking purposes.

The *Application of Lake Monticello Service Co.* case provides the necessary guidance to resolve this issue. In that case, the Hearing Examiner determined that the parties before the Commission might have a private contract dispute over which the Commission had no jurisdiction. However, he further determined "[a]s a ratemaking matter, however, I cannot see that the evidence in this record merits disapproval of the Company's use of connection fees for the purpose of building the central water and sewerage treatment plants." (Report of Stewart E. Farrar, Hearing Examiner, at 7, (May 3, 1983)). The Hearing Examiner reviewed all of the evidence in the record and concluded, contrary to the position advocated by the homeowners' association, that the Service Company was not precluded by the language of the HUD land reports or the promissory notes signed by many of the lot owners from using connection fees to make capital improvements to the central water and sewer systems. Likewise, it is entirely proper in this case, for ratemaking purposes, to review the terms of the sales contract between BCC, Inc. and the Company that is in the record to determine the proper rate base for the Company.

I agree with the Protestant that the sales contract should be interpreted in its entirety, with an eye towards harmonizing the various provisions of the contract. Unfortunately, no party in this case has undertaken such an analysis. The sales contract provides, in relevant part, that:

> WHEREAS, Seller (BCC, Inc.) hereby agrees to sell and Buyer (the Company) hereby agrees to buy the hereinafter described real estate upon the terms and conditions set forth herein;
>
> NOW, THEREFORE, in consideration of the premises and the mutual covenants contained herein, the parties agree as follows:
>
> 1. PROPERTY TO BE CONVEYED. Seller agrees to sell and Buyer agrees to buy the following described real estate, all located in the Mt. Tabor Magisterial District of Montgomery County, Virginia:
> A. Lots 109, 110, 111, 112, 113 and 208 ….
> B. Lots 302, 308, 310, 311, 312, 313, 315, 401, 402 and 406….
> C. Lots 501, 502, 503, 504, 505, 506, 507, 508, 509, 510, 511, 512, 513, 514, 515, 516, 517, 534, 535, 536, 537, 538, 539, 540, 541, 542, 543, 545, 546, 547, 548, 740, 741, 742, 743, 744, 745, 746, 747, 748, 749, 750, 751, 755, 756 and 757….
> . . . .
> 2. PURCHASE PRICE. In consideration of the above referenced conveyances, Buyer shall perform as follows:
> A. Pay off at settlement Seller's existing Greenbrier Circle Construction Loan at the National Bank of Blacksburg, which has a current balance of approximately $41,957.22, provided, however, that all net proceeds from the sale of any lots currently under contract shall be used to curtail this debt.
> B. Build or upgrade to Virginia Department of Transportation standards and dedicate to the State System, all roads, and bridges necessary to serve current lot owners, in a timely fashion. Until dedication to the State System, Buyer shall maintain all currently private roads to State Standards, including snow removal. This obligation shall survive settlement.

C. Provide sanitary sewer service to the property line of all lots currently owned by individuals and not currently served by sanitary sewer. However, the parties acknowledge that said obligation shall not run to Lots 730, [752], 753 and 754, Blacksburg Country Club Estates, Section III. This obligation shall survive settlement.

D. Generally assume any and all of Seller's real estate development and operations obligations not enumerated above in regard to all phases of Blacksburg Country Club Estates. This obligation shall survive settlement.

. . . .

6. ADDITIONAL TERMS AND CONDITIONS WHICH SHALL SURVIVE SETTLEMENT. The parties agree to the following additional terms and conditions, and agree that responsibility for their performance shall not be merged with settlement, but rather shall independently survive settlement:

. . . .

K. Buyer shall be entitled to receipt of any and all future sewer connection fees paid by any lot owner in the Blacksburg Country Club Estates. The parties agree and acknowledge that the only vacant lots for which such connection fee have already been paid are Lots 314, 622, 720, 722, 726 and 739. In the event, however, that any lot owner should provide a legitimate receipt showing payment for any other lot or lots, Buyer agrees to honor said receipt.

. . . .

O. The parties agree and acknowledge that Buyer's obligation to operate and maintain the sewerage treatment plant shall extend indefinitely, or until the county or some other public service authority assumes its operation. Buyer reserves the right to establish a separate, self-sustaining corporation or other entity to operate said plant. [(Buyer) agrees that it will continue the operation of the sewerage treatment plant for the existing customers.]

Exhibit JM-10, Document JGM.e "sales contract."

The parties in this case have focused their analysis on the provisions of the contract dealing with the property to be conveyed and the purchase price. They have generally ignored the additional terms and conditions and how they impact the remainder of the contract. The intention of BCC, Inc. and the Company as expressed by them in the language they used in the sales contract governs the contract's construction. A court must determine that the parties to the contract intended what the written instrument plainly declares. *Lenders Financial Corp. v. Talton*, 249 Va. 182, 190, 455 S.E. 2d 232, 236 (1995).

In looking at the entire contract, three points become readily apparent. First, as the Protestant and the Staff have noted, the language of the consideration portion of the sales contract makes it abundantly clear that, in return for a number of undeveloped lots for which it paid nothing, the Company obligated itself to extend the sewer system it just acquired to every individually owned lot that was not currently served by sanitary sewer. The Company obligated itself to install sewer mains, but not the laterals, to those lots. The sales contract clearly states the Buyer shall "[p]rovide sanitary sewer service <u>to the property line</u> of all lots currently owned by individuals and

not currently served by sewer." The undeveloped lots represent a contribution in aid of construction to cover the cost of meeting the Company's obligation under the contract.

Contrary to the Protestant's interpretation of the contract, I fail to find the language of the contract supports the extension of sewer mains to the remaining lots in the subdivision. The Protestant argues Section 2.D of the Purchase Price requires the Company to extend the sewer mains to all the remaining lots in the subdivision at no cost to the sewer company's customers. I disagree. At the time the contract was executed, BCC, Inc. was contractually liable, as the former developer of the subdivision to provide sewer service to all the lots it had sold. The Company assumed this liability in return for the undeveloped lots, which could be sold to provide the capital necessary to make the required sewer main extensions. The Company assumed no corresponding liability with the undeveloped lots it acquired. The liability to install sewer mains for these lots would arise when they were sold, and that liability would rest solely with the Company.

The second point, the right to collect connection fees found in Section 6.K of the sales contract, now becomes critical to the interpretation of the contract. Under this provision, the Company is entitled "to receipt of any and all future sewer connection fees paid by any lot owner in the Blacksburg Country Club Estates." (*Id*.). Historically the connection fee collected by BCC, Inc. included the cost of extending both the sewer mains and laterals into new sections of the subdivision. Under the terms of the contract, the Company succeeded to this right. If the Company was already compensated for extending the sewer mains to individually owned lots, then it could only collect from the individual lot owners a connection fee or capital contribution that represented the cost of installing the lateral. The Company is not otherwise restricted with the undeveloped lots it acquired in the sales contract. The language of the contract supports the Company charging a connection fee or capital contribution on the lots it acquired that includes the cost of installing sewer mains and laterals to serve those lots.

The implications of my interpretation of the sales contract to the Company, and its customers, are profound. The attached Hearing Examiner's Worksheet 3, shows the calculation of the number of lots that were individually owned at the time of the sales contract which required sewer main extensions (73), and the number of lots that the Company acquired under the sales contract which also required sewer main extensions (36). These calculations were performed by the Company and the Staff.

On the attached Hearing Examiner's Worksheet 4, I calculated the average cost to extend a sewer main to a lot, and then used that number to calculate the CIAC the Company received in the form of undeveloped lots to reimburse it for extending the sewer mains to all individually owned lots not served by sanitary sewer. Because the Company did not segregate the costs for the sewer system expansion between individually owned lots and Company owned lots, I calculated an average cost per lot. In its rebuttal testimony, the Company reported it spent $382,878 on sewer system expansions. From this amount, I deducted the cost of installing 11 laterals to homes where there was no corresponding sewer main construction. Mrs. Moore provided this number in her direct testimony; it was not rebutted by the Company. The number was based on her personal observations of utility construction occurring in BCC Estates. This resulted in a cost of $355,378 to install sewer mains and laterals to 35 individually owned lots and 31 lots owned by the Company. Again, Mrs. Moore supplied the number of lots where sewer service expansions, mains and laterals,

were made. These were also based on her personal observations of utility work occurring in BCC Estates, and the Company did not refute these numbers. I then deducted the $2,500 cost claimed by the Company as the cost for installing a lateral for the 66 homes where mains and laterals were installed. This resulted in the $190,387 cost to install sewer mains only to these 66 lots. I then divided the $190,387 by the number of lots to arrive at the Company's average cost, $2,885, to extend a sewer main to a lot. I then multiplied that average cost by the 73 individually owned lots not served by sewer service, to arrive at a cost of $210,605 for extending sewer mains to serve these lots. The $210,605 represents the CIAC the Company received from the undeveloped lots acquired in the sales contract. Since the costs for the installation of the sewer mains in the subdivision were not segregated between individually owned lots and Company owned lots, the methodology I employed represents a reasonable way to properly account for the CIAC the Company received in the undeveloped lots.

On the attached Hearing Examiner's Statement 1, the effects of including the additional $210,605 in rate base as CIAC are calculated.[16] The overall effect of making this adjustment is an increase in return on rate base to 6.67 percent. By comparison, the Company calculated a return on rate base of 0.04 percent, and the Staff calculated a return on rate base of 1.07 percent, without including the CIAC from the undeveloped lots.

The sales contract also supports the notion that additions to the sewer system's utility plant should be offset by capital contributions or CIAC. Under Section 6.O of the contract, it was contemplated that at some point the system might be turned over to a public service authority to operate. Offsetting utility plant additions with capital contributions or CIAC produces a net utility plant at or near zero. This would enable the public service authority to assume operations of the sewage utility at little or no acquisition cost.

In summary, I find the entire $110,000 in connection fees collected by the Company since it acquired the sewer system should be included in the Company's rate base as CIAC. In addition, I find the Commission has the jurisdiction to review, for ratemaking purposes, the terms of the sales contract to determine whether the undeveloped lots received at no cost by the Company under the sales contract were a CIAC to complete the installation of sewer mains to all lots owned by individuals, but not yet served by sanitary sewer. The plain language of the contract indicates that such was the case. Consequently, an additional $210,605 should be included in the Company's rate base as a CIAC. This number reflects the cost to extend sewer mains to the 73 individually owned lots. I further find the sales contract permits the Company to continue charging connection fees that are in substance a capital contribution or CIAC. For the individually owned lots the sewer connection fee of $2,500 would cover the cost of installing the lateral. For the lots acquired by the Company, the connection fee would cover the cost of installing both the sewer mains and the laterals to serve these lots. The Commission should set the connection fee for these lots at $5,000 ($2,500 lateral cost + $2,885 average cost for installing a sewer main to a lot = $5,385 ~ $5,000).

The Company requested a management fee in the amount of $24,000 to cover a portion of Mr. Reynolds' annual salary. Mr. Reynolds is the certified operator of the sewage utility and he spends at least four hours of his day maintaining the system and conducting the necessary tests required by its operating permit. In addition, the Company requested an accounting fee of $4,000 to

[16] Included with Hearing Examiner's Statement 1 is Worksheet 1, a Depreciation and Amortization Schedule.

cover the cost of accounting services rendered by an affiliated company. The Staff found these expenses to be reasonable. The Protestant, however, argued the expenses related to Mr. Reynolds' services appeared to be inflated. She based her opinion on a comparison of 1999 test year expenses of $24,000 with the corresponding expenses incurred in 1998 of $9,968. She also noted that approximately $8,000 of the amount claimed by the Company represented travel time for Mr. Reynolds to travel from his office in Roanoke to the sewage utility in Blacksburg and back each day. She believes there is nothing that can be done in this case, but the Company should be encouraged to reduce costs by finding a competent local Class IV operator to take over the system's daily chores.

Although operations at the utility have increased with the improvements to the sewer treatment plant, expansion of the sewer system, and the construction necessary to make these improvements, it is difficult to imagine, on a going forward basis, that the cost to operate this system has increased by 140 percent. On this record, I am willing to approve the Company's requested management fees. The evidence indicates that the Company is operating a model sewage treatment facility. There is some question whether this was the case under the former management. I would encourage the Company to strive to operate this utility in the most efficient manner possible. To that end, the Company may wish to explore whether it makes more sense for Mr. Reynolds to report directly to the utility, rather than his office, in an effort to reduce the time spent traveling each day. I agree with the Protestant that an inordinate amount of his time is spent traveling to and from the utility. In future rate proceedings, the Staff should require more than one estimate to perform like services before passing on the reasonableness of the Company's management fee. I recommend that the Commission approve the Company's requested $28,000 in management and accounting fees.

Early in this case, the Staff recommended that the Company place the sewage utility in a subsidiary separate from its development company. The Company attempted to do this but ran afoul of its DEQ operating permit. DEQ would not transfer the Company's operating permit until the Commission issued it a CPCN. The Company incurred $1,080 in expenses related to the organization of CCWWS. The Company and the Staff agree that this amount should be capitalized. However, the Protestant argues the Commission should not allow the organizational costs for CCWWS in rate base until the Commission approves the transfer of the Company's CPCN to CCWWS.

This case was unnecessarily complicated by the fact the Company had failed to separate its development operations from its sewage utility operations. Rather than penalize the Company by removing the cost from rate base, I believe the better course of action would be to leave the cost in rate base, and require the Company to file an application to transfer its CPCN to CCWWS within 90 days from the date of the Commission's final order in this case. The Company could more effectively manage, and the Staff could more effectively monitor, the expenses incurred by the sewage utility if it were in a separate operating subsidiary. I recommend the Commission order the Company to file an application to transfer its CPCN to CCWWS within 90 days from the date of the final order in this case.

The Staff recommended that the Commission order the Company to maintain a separate set of books in accordance with the USOA for Class "C" wastewater utilities. The Company requested

that it be given at least 90 days after the Commission enters its final order in this case to complete the conversion of its books to the USOA. The Protestant took no position on this issue. I find that 90 days is a reasonable period of time to allow for the orderly conversion of the Company's books to the USOA. If the Company requires additional time, especially if difficulties arise in spinning off the sewer utility into CCWWS, it could always file a motion for extension with the Commission. I recommend that the Commission allow the Company 90 days from the date of the final order in this case to convert its books to the USOA.

Rules and Rate Design Issues

The Company is proposing a $2,500 connection fee that would be treated as a one-time capital contribution or CIAC. The Company argues that it should not be penalized for installing the laterals at the same time it installed the sewer mains. The Company argues it was much more efficient and less costly to install the laterals at that time. The Company introduced evidence that, on average it cost approximately $2,500 to install a sewer lateral. The Staff is opposed to any connection fee or one-time capital contribution or CIAC. The Protestant is in favor of a $2,500 one-time capital contribution or CIAC. She believes that in fairness to existing lot owners who paid connection fees, future lot owners should likewise be required to make a capital contribution to the utility.

I agree with the Protestant that fundamental fairness requires that future lot owners make a one-time capital contribution or CIAC. As discussed previously, the sales contract permits the Company to continue collecting connection fees. Historically, these connection fees were a capital contribution or CIAC to offset the cost of constructing sewer plant extensions into new areas of the subdivision. The costs for those sewer plant extensions were pro rated among the potential customers to be served, and then collected in the form of a sewer connection fee. Consistent with my previous discussion concerning the sales contract, I believe the parties intended the Company to collect a capital contribution or CIAC from individually owned lot owners to recover the cost of installing the lateral. The Company has proposed a one-time capital contribution or CIAC of $2,500 to recover the cost of installing sewer laterals to serve these lots. The Commission should permit the Company to charge the owners of the 73 individually owned lots a one-time capital contribution or CIAC in the amount of $2,500 at the time they connect to the sewer system. For each of the 36 developable lots owned by the Company, the Commission should permit the Company to charge a one-time capital contribution or CIAC of $5,000 at the time they connect to the sewer system. As supported by Hearing Examiner's Worksheet 4, this amount represents an approximate average cost of installing the sewer mains and the laterals to serve each of these lots. This would allow the Company to maintain the cost of its utility plant in service at or near zero, and would facilitate the possible future acquisition of the utility by the Montgomery County Public Service Authority. Since the time it filed its Application, the Company may have over- or under-collected, the one-time capital contribution or CIAC from lot owners. The Commission should order the Company to make the appropriate refunds, or make the additional capital contributions or CIAC assessments, as the case may warrant, for sewer connection fees collected after the date of the Commission's Order docketing this case and suspending the Company's proposed $17,500 sewer connection fee.

Since the Company has a history of using sewer utility funds for its other development operations, I recommend that the Commission order the Company to maintain all one-time capital contributions or CIAC collected after the date of the Commission's final order in this case in a separate interest bearing escrow account. The escrow account would be used solely for future capital improvements to the sewer plant or system. The Commission should further order the Company to use sewer connection fees collected prior to the date of the Commission's final order solely to retire debt associated with the sewer utility.

The Company proposed a $34 per month residential sewer rate and a $20 per month sewer availability rate. These rates are comparable to other sewer rates in the surrounding area. As adjusted in this Report, they should produce a 6.67 percent return on rate base. The Staff testified the proposed rates are reasonable. The Protestant argued the imposition of an availability fee is inappropriate when the sewer collection system is not included in rate base. She further argued the prime beneficiaries of the availability rate are those lot owners who have not paid a sewer connection fee. The Protestant argues an availability fee of $60 per year, for the next five years, would be justified to pay off the costs of this rate proceeding, and provide some indirect rate relief to homeowners. Finally, the Protestant argues the availability rate should apply only to lots for which a sewer connection fee has not been paid.

Notwithstanding the Protestant's argument to the contrary, I find the $34 per month residential sewer rate and the $20 per month availability rate to be reasonable. On this issue, the Protestant's argument is premised on the fact that she has not included the sewer collection system in rate base. As set forth above, the lots transferred in the sales contract were intended to compensate the Company for extending sewer mains to those lots that were individually owned at the time of the transfer, not all the remaining lots in the subdivision. As adjusted in this Report, the Company has a total rate base of $177,698, not zero as argued by the Protestant. In this instance, it is entirely appropriate to collect an availability fee from the vacant lot owners to pay the interest on the debt used to extend the sewer collection system to serve them. I recommend that the Commission approve the Company's requested $34 per month residential sewer rate and the $20 per month availability rate.

The Company proposed a service connection charge for commercial and industrial customers that consisted of the actual cost to connect the customer plus a gross-up for taxes and applicable charges, but in no event less than $2,500. Additionally, the Company proposed a sewer rate for such customers of $350 per month, plus the actual cost of any chemicals and supplies to treat the sewage discharged by such customers. The Company proposed a minimum monthly charge of $350 for these customers. The Staff opposed these commercial charges because the Company failed to propose these charges in its original application, and they were not included in the Company's public notice to its customers. The Company agreed with the Staff and withdrew its request for these charges.

In the sales contract, the Company agreed to provide the Blacksburg Country Club free sewage service for a period of five years after the date of the contract, and then charge the Country Club a rate of four times the prevailing homeowner rate. The Staff argued the Commission should impute $136 per month in revenues to the Company in calculating its revenue requirement for agreeing to provide free sewage service to Blacksburg Country Club. The Protestant agrees with

the Staff. The Company does not object to the Staff's proposal. Accordingly, I find that $136 per month in revenue should be imputed to the Company to recognize revenues that it agreed to voluntarily forego. I recommend that the Commission impute $136 per month in revenues to the Company in calculating its revenue requirement.

The Company proposed a $20 bad check charge and a late payment fee of 1½ percent per month. The $20 bad check charge represents the Company's actual cost for processing a bad check submitted by a customer. Neither the Staff nor the Protestant opposes the bad check charge or the late payment fee. I find the record supports the Company's $20 bad check charge, as cost-based. I further find the Company's late payment fee of 1½ percent per month to be reasonable. I recommend the Commission approve the Company's $20 bad check charge and a 1½ percent per month late payment fee.

The Company proposed a $25 turn-on charge to restore service discontinued for either non-payment of a bill, a violation of the Company's tariff, or at the request of the customer. The charge is cost-based. The charge and any arrears owed the Company must be paid before sewage service is restored. The Staff and the Protestant found the charge to be reasonable. I likewise find the $25 turn-on charge to be reasonable, and I recommend the Commission approve it.

In its Application, the Company initially proposed a $5,000 disconnection and reconnection charge. The Commission suspended this charge altogether in its order docketing this case. In its prefiled testimony, the Company reduced these charges to the actual cost of performing a disconnection, and the actual cost of performing a reconnection. The Company argues the disconnection charge would be imposed when it becomes necessary to physically disconnect sewer service to a customer. The Company would impose the disconnection charge, which could include the removal of the entire lateral serving the home, in cases where a discontinuation of service was unsuccessful in remedying the customer's offensive conduct, or the home was completely destroyed by fire or other natural disaster. The Company would impose the reconnection charge, which could include re-installing the entire lateral, on a customer who has been disconnected. The Company argues the charges are justified and should be approved.

The Staff argues the disconnection and reconnection charges are speculative and the Company has provided no cost basis for the fees. The Staff believes Company may never employ the procedure. The Staff believes that a discontinuation of service, which involves placing a balloon valve in the sewer clean-out in the lateral, which prevents sewage from flowing into the system, is enough of an incentive to encourage a customer to comply with the Company's tariff.[17] This service is covered under the Company's turn-on charge.

The Protestant believes the charges appear reasonable.

The Company has done a poor job of articulating the circumstances under which it would employ the disconnection charge and the reconnection charge, and specifically what would be done in such circumstances. Under the charges, the Company would be entitled to remove the entire lateral and charge the customer the cost of removal, and then turn right around and charge the

[17] The fundamental laws of physics apply. If the balloon valve prevents the sewage from flowing into the system, it will follow the path of least resistance, which in this case would be back into the home.

customer again to reinstall the lateral. If a customer is delinquent in his bill, it seems rather extreme to remove the entire lateral when a discontinuation of service would motivate 99.99 percent of the customers to pay their bill. The customer would certainly receive the Company's message that the delinquent bills must be paid when raw sewage began backing up into their home. In the other instance cited by the Company, where a home is destroyed by fire or other natural causes, it still makes no sense to remove the entire lateral, and then re-install the lateral after the home is rebuilt. In this instance, it would make more sense to leave the lateral in place and excavate on the customer's side of the sewer clean-out and cap the pipe leading to the house. The Company could then leave a piece of pipe exposed, as it did when it installed the lateral, to mark the end of the lateral for the homeowner's benefit. At least the lateral would already be in place when the home is rebuilt. The Company went through a great deal of effort in this case justifying the monies it expended to install the laterals when they installed the sewer mains. On this record, I cannot understand why they would be so eager to remove the very same laterals. In many cases, the laterals pass underneath the streets in the subdivision. I do not know whether the Company intends to charge the customer the cost of tearing up, and then repairing the street when the lateral is removed, only to have to tear up and repair the street again when the lateral is reinstalled. I find the Company failed to justify its need for a disconnection and reconnection charge. I recommend that the Commission deny the Company's proposed disconnection and reconnection charges.

The Company's proposed Rule No. 20 explains its sewer main extension policy. The provision provides, in part, that, if the cost to extend a sewer main is less than 3½ times the estimated annual revenue from the potential customer or customers, the Company will install the main at no cost. If the cost to install the main is greater than 3½ times the estimated annual revenue from the potential customer or customers, the customers are required to deposit with the Company the difference between the estimated cost of the main and the 3½ times the annual revenue from the customers to be served by the main. The provision allows for refunds to customers if additional connections are made to the main and the total revenues generated from the main exceed the 3½ times test. The Company argues the language is similar to that contained in other utilities' tariffs.

The Staff does not oppose this provision.

The Protestant objects to the sewer main extension language in the tariff. She argues the language should be modified to be consistent with past development practices in BCC Estates. She argues the Company should be responsible for the installation of all sewer mains and laterals in the future. Her position is premised on her interpretation of the sales contract and its requirement that the Company had to "assume any and all of [BCC, Inc.'s] real estate development and operations obligations not enumerated above in regard to all phases of [BCC] Estates." (Ex. JM-10, at Document JGM.e, page 3).

As set forth more fully above, I disagree with the Protestant's interpretation of this portion of the sales contract. Consistent with the recommendations in this case, the Company may charge a one-time capital contribution or CIAC of $5,000 to each lot owner of the 36 developable lots it acquired in the sales contract to defray the cost of installing sewer mains and laterals to serve those lots. The sewer main extension policy proposed by the Company appears to apply to future expansions of the Company's service territory, not to the lots that are the subject of this case. I find

the Company's proposed sewer main extension rule in its tariff to be reasonable. I recommend that the Commission approve the Company's sewer main extension rule.

Protestant's Issues

The Protestant raised five issues in this case: (1) the impact of the December 14, 1995, real estate sales contract; (2) the impact of the October 22, 1996, performance agreement between the Company and Montgomery County; (3) the Company's proper rate base, taking into account the real estate sales contract; (4) the Company's proper utility plant in service based on the real estate sales contract; and (5) the Company's proper level of contributions in aid of construction. With the exception of issue (2), the Protestant's issues have been addressed in the preceding sections of this Report.

The performance agreement between the Company and Montgomery County, raised in Protestant's issue (2), is not critical to the determination of the Company's net utility plant. It is, however, further evidence that the Company agreed to make sewer service available to all lots that were currently owned by individuals and not served by sewer service, in return for the conveyance of the undeveloped lots in the sales contract. (*See*, Ex. JM-10, Document JGM.h).

In her post-hearing brief, the Protestant raised several additional issues, some of which may be addressed in this proceeding, and some of which will have to be addressed in future proceedings.

First, the Protestant is concerned the Company's service area has not been adequately defined. The various witnesses have defined the service area as: BCC Estates; BCC and surrounding areas; and, customers at BCC, near the community of Ellett in Montgomery County, Virginia. The Protestant argues the Company should be limited to providing sewage service to the country club and the 242 platted lots in BCC Estates. In its Application, the Company requested a service territory that included the BCC Estates, Montgomery County, Virginia. This is a sufficient description to define the Company's service territory in its CPCN. In the future, if the Company seeks to expand its service territory, the Company will need to file an application with the Commission and provide public notice of its application to its customers. The merits of the Company's application will determine whether the Commission would approve a service territory expansion in the future.

Second, the Protestant recommends the Commission monitor the Company's capital expenditures and pre-approve any expenditure over $5,000, except emergency expenditures. The Commission does not have the authority to impose such a restriction on a sewage utility. However, it does have the ability in the Company's next rate case to disallow unsupported capital expenditures from the Company's rate base.

Third, the Protestant is opposed to the Company acquiring a $15,000 wheeled generator. The generator would be used to run the sewage pumping stations when the electric power is out in the subdivision. DEQ recommended that the Company acquire the generator. The Protestant argues everyone in the subdivision obtains his or her water from a well. If the electric power were out in the subdivision, homeowners could not pump water out of their well. Therefore, they would

not be discharging wastewater into the sewage system. The flaw with this argument is that some homeowners in the subdivision may have their own portable generators to supply electric power to their homes. In that case, they would have the ability to pump water out of their wells and discharge wastewater into the sewage system. If the pumping stations were not working and wastewater was being discharged into the system, the possibility of a sewage spill exists. It makes good sense for the Company to purchase a wheeled generator to provide back-up power for its sewage pumping stations.

Finally, the Protestant is concerned that before the sewage utility is transferred from the Company to CCWWS, the terms of the transfer should be made public and a comment period provided. The value of the sewage system at the time of transfer needs to be determined, and the obligations and the rights set forth in the sales contract would need to transfer. These issues are not properly before the Commission. The Commission should address these issues when the Company files its application to transfer ownership of the sewage utility.

FINDINGS AND RECOMMENDATIONS

Based on the evidence received in this case, and for the reasons set forth above, I find that:

(1) The Company should be issued a CPCN to operate a sewage utility in the Blacksburg Country Club Estates, Montgomery County, Virginia;

(2) The Company's adjusted total revenue requirement of $71,760 is reasonable;

(3) The Company should be permitted to include $23,259 in capitalized interest in its rate base;

(4) The Company should include $110,000 in connection fees collected since it assumed operations of the sewage utility in rate base as a CIAC, as set forth in Hearing Examiner's Statement 1 attached hereto;

(5) The Company should not be permitted to use $30,000 in sewer connection fees collected from its customers to pay off the outstanding construction loan for the Greenbrier Circle development;

(6) The Commission has the jurisdiction to review the sales contract entered into between the Company and Blacksburg Country Club, Inc. to determine the Company's proper rate base for ratemaking purposes;

(7) The Company should include $210,605 in rate base as a CIAC to recognize the value of the undeveloped lots it received as consideration in the sales contract to extend the sewer collection system to all lots that were individually owned, but not yet served by sanitary sewer, as set forth in Hearing Examiner's Statement 1 attached hereto;

(8) The Company's requested management fee of $24,000 and accounting fee of $4,000 are reasonable;

(9) The $1,080 in organizational expenses for CCWWS should be included in rate base and capitalized;

(10) The Commission should require the Company to file an application within 90 days after the final order in this case to transfer its CPCN to CCWWS;

(11) The Company should be permitted a period of 90 days from the date of the Commission's final order in this case to convert its accounting records to the Uniform System of Accounts for Class "C" wastewater utilities;

(12) The Company should be permitted to charge a $2,500 one-time capital contribution on each of the 73 lots that were individually owned at the time the sales contract was entered to recover the cost of installing sewer laterals to serve these lots, and account for this contribution as CIAC;

(13) The Company should be permitted to charge a $5,000 one-time capital contribution on each of the 36 developable lots it acquired in the real estate sales contract to recover the cost of installing sewer mains and laterals to serve these lots, and account for this contribution as CIAC;

(14) The Company should be required to make the appropriate refunds, or additional CIAC assessments, as the case may warrant for sewer connection fees collected after the date of the Commission's order docketing this case and suspending the Company's proposed $17,500 sewer connection fee;

(15) The Company should be required to deposit all capital contributions or CIAC collected after the date of the Commission's final order in this case into a separate interest bearing account to be used solely for future capital improvements to the sewage utility;

(16) The Company should be required to use all capital contributions or CIAC collected prior to the date of the Commission's final order in this case solely to retire the debt associated with the sewer utility;

(17) The Company's $34 per month residential rate and $20 per month availability rate are reasonable;

(18) The Commission should impute $136 per month in revenues to the Company in calculating its revenue requirement for agreeing to provide free sewage service to the Blacksburg Country Club;

(19) The Company's proposed $20 bad check charge and 1½ percent per month late payment fee are reasonable;

(20) The Company's proposed $25 turn-on charge to restore sewage service after a discontinuation of service is reasonable;

(21) The Company failed to justify the need for its proposed disconnection and reconnection fees, therefore, the Commission should deny these fees;

(22) The Company's sewer main extension policy in its tariff should be approved;

(23) The Commission does not have the authority to require the Company to obtain prior approval of every capital expenditure in excess of $5,000;

(24) The Company should be permitted to acquire a wheeled generator to provide back-up electrical power for its sewage pumping stations; and

(25) The Commission should address the issues related to the transfer of the assets of the sewage utility to CCWWS at the time the application for such transfer is filed with the Commission.

I therefore ***RECOMMEND*** the Commission enter an order that:

(1) ***ADOPTS*** the findings contained in this Report;

(2) ***GRANTS*** the Company a certificate of public convenience and necessity; and

(3) ***DISMISSES*** this case from the Commission's docket of active cases and passes the papers herein to the file for ended causes.

COMMENTS

The parties are advised that any comments (Section 12.1-31 of the Code of Virginia and Commission Rule 5:16(e)) to this Report must be filed with the Clerk of the Commission in writing, in an original and fifteen (15) copies, within thirty (30) days from the date hereof. The mailing address to which any such filing must be sent is Document Control Center, P.O. Box 2118, Richmond, Virginia 23218. Any party filing such comments shall attach a certificate to the foot of such document certifying that copies have been mailed or delivered to all counsel of record and any such party not represented by counsel.

Respectfully submitted,

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Michael D. Thomas
Hearing Examiner